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DISCOUNT BROKERAGE

AND THE ROLE OF

FINANCIAL INSTITUTIONS

Evidence of
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filed on behalf of the

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Combines Investigation Act

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EXECUTIVE SUMMARY

Issues relating to the role of financial institutions in discount brokerage have important implications for the competitive environment in the securities industry. Resolution of these issues must recognize that the intent of unfixing brokerage commission rates was to encourage increased competition and create opportunities for beneficial service innovations such as discount brokerage.

The current regulatory framework was designed prior to the introduction of competitive commission rates and the appearance of the technological and market developments which have given rise to the current testing of the boundaries between the functions of securities dealers and other sectors of the financial services industry. It cannot be assured that current regulations are appropriate for protecting the public interest in today's environment. For this reason, it is appropriate to address the issues relating to the role of financial institutions in discount brokerage by examining regulatory and market structure alternatives, rather than simply by seeking a legal interpretation of current regulations.

Increased cooperation between securities firms and financial institutions is an innovation which can serve the public interest. However, the form of their cooperative arrangements (network relationships), which are determined in part by regulation, will have a major impact on the extent to which the potential benefits in the public interest are realized.

Competition among securities dealers and among exchanges should be facilitated, rather than impeded by regulation. Specifically, discount brokers that do not engage in solicitation or advising of clients need not be bound by the normal consumer protection instruments (suitability rules). This will make the cheapest possible brokerage service available to investors who are sufficiently sophisticated or single-minded to willingly forego such protection. The manner in which clients should be able to waive the suitability rule presumably will be the subject of separate deliberations by the Commission.

Direct competition between securities dealers and financial institutions such as banks may lead to detrimental outcomes including conflicts of interest and increased concentration in the securities industry, resulting in part from regulatory asymmetries rather than normal market forces.

Since the experience of other jursidictions provides little help in reliably predicting the severity of these effects in the Canadian context, views concerning the importance of these concerns are quite speculative.

These concerns, as serious or trivial as they may be, potentially exist whether banks enter the business of offering brokerage services by performing execution services themselves (which, because of ownership restrictions and the Bank Act, presently cannot be done) or by contracting securities dealers to execute the trades on their behalf. This is so because the introduction of price competition in the securities industry has minimized the consequences of entry barriers.

On the other hand, to rigidly maintain the traditional separation of functions will deny investors the

potential convenience and savings that could be enjoyed if recent technological and market developments are realized in part through the integration and packaging of traditional brokerage and banking functions within the financial services sector.

A middle road may exist which averts the potential anti-competitive effects associated with a significantly increased role for financial institutions in the direct supply of retail brokerage services, while facilitating the development of an efficient, integrated administrative system for linking banking and brokerage functions. This route will serve as a beneficial first step which will leave open the possibility of expanding the role of financial institutions at a later date when the market response to the new service package is known.

The recommended approach is to encourage the cooperation of banks and brokers to offer a service like the Toronto-Dominion Bank's proposed "Green Line Investor Service" in all respects but one. The suggested deviation is that investors would place their orders with a securities dealer rather than the bank's trading clerk. The receiving broker would get an authorization from the bank, if necessary, prior to accepting the order. Once the order is accepted, the broker would execute it and transmit the relevant information directly to the investor's bank where his Stock 'n Trade account (or equivalent) would be appropriately debited or credited.

This approach realizes the benefits of competition, while recognizing that since the current market structure

reflects historical regulatory restrictions and that truly free competition is restricted by many regulatory constraints beyond the O.S.C.'s jurisdiction, the removal of a single impediment to competition at this stage in the development of Canada's financial services sector does not ensure an improved competitive environment. It may be desirable to review these restrictions on the role of financial institutions at a later date in light of future regulatory and market developments.

PART I

INTRODUCTION

The issues raised by the Ontario Securities Commission in its Notice of Meeting dated 5 May 1983 deal primarily with the evolution of the competitive and regulatory environments of the brokerage industry. As an aid to formulating policy with respect to these issues, it is useful to clearly identify several distinct forms of competition in the financial services sector. It is deceptively simplistic to ask only whether it is in the public interest to increase competition. The real question is what form of competition will best serve the public interest given the current market and regulatory realities.

Consequently, this paper focusses on developing a framework for policy formulation which distinguishes among several forms of competition. The benefits and costs which are attributed to increasing the role of financial institutions in the provision of brokerage services are shown to depend on the competitive role of the financial institutions. The analytic framework outlined in this paper identifies which aspects of the competitive environment are likely to achieve the desired benefits and which are likely to risk the costs that are of concern. This approach facilitates identifying a competitive market structure which maximizes the benefits and minimizes the costs in defining the role of financial institutions in the provision of discount brokerage services.

The analysis presented in this paper flows from the views presented in the Director's submissions at the O.S.C.'s 1981 hearing, which led to the unfixing of brokerage

commission rates, and at the 1982 hearing on institutional ownership and diversification in the securities industry. It is intended to provide a general framework for the policy positions on the many competitive issues which face the O.S.C. and other regulators of the financial services sector.

Normally, it is in the public interest to facilitate competition. From an efficiency viewpoint, restrictions of competition can only be justified where special circumstances lead to market failure. In these instances, restrictions are justified to the extent that they increase the competitive efficiency of the market. (From a broader perspective, government may choose to impose regulation in an area of economic activity for a variety of reasons ranging from the concerns inherent in the classic natural monopoly case to a desire to attain any number of broad social goals not normally expected to result naturally from the free interplay of market forces.) If regulatory intervention is deemed necessary, the method of intervention should be that which achieves the desired end in a manner least restrictive of competition. Regulatory intervention is justified not to protect special interests, such as those of the industry being regulated, but only to serve the broader public interest.

Within the financial services sector, a variety of separately regulated industries with different functions compete for domestic savings. Most notably, commercial banks historically have been primarily concerned with intermediating as principals between savers and users of funds (often referred to as "financial intermediation"), while securities firms have acted primarily as agents or brokers, effecting transactions in securities on behalf of

savers and users of funds (often referred to as "market intermediation"). The latter have had an exclusive franchise for access to the secondary securities markets. However, with the advent of price competition the economic value of that franchise has been eroded and, barring the imposition of new regulatory barriers, will continue to decline even if market and financial intermediaries restrict themselves to their traditional functions.

There has always been a "grey area" where the primary functions performed by financial and market intermediaries intermingle. As new service packages are fashioned in response to increased domestic and international competition within the financial services sector, this intermingling becomes more pronounced and the grey area broadens. As a result, new demands are being made on regulatory bodies to demarcate and "police" the interface between the participants in the financial services sector.

The introduction of barriers to competitive innovation within the securities industry and in the relation of securities firms to other providers of financial services could undermine the O.S.C.'s decision to unfix brokerage commission rates. The introduction of competitive commission rates allows the development of new service alternatives which will afford investors a broad choice of services and an opportunity to reduce their transactions costs. To allow cooperation to develop between various segments of the financial services sector, while retaining certain functional distinctions which may be in the public interest, would benefit both investors and Canada's capital markets by promoting beneficial innovation.

In particular, competitive innovation might best be achieved in the near term by encouraging intermodal competition through administrative networking relationships, as defined in Part VI. The proposed approach recognizes the risk that unrestricted competition could have anti-competitive effects for intermodal competition due to the size and economic power of certain financial intermediaries. However, administrative networking can circumvent the danger by retaining separation of function without building an unnecessarily rigid regulatory wall between the securities industry and financial intermediaries. Complete separation will deny investors and Canadian capital markets the substantial benefits that would flow from the recommended approach.

Part II of this paper reviews the background events which have led up to the O.S.C.'s proposed meeting and outlines the existing regulatory framework. Parts III, IV and V analyze the potential benefits and costs of intramodel competition, intermodal competition and networking, respectively. Finally, Part VI summarizes the arguments and conclusions.

PART II

BACKGROUND TO THE MEETING

As the Notice of Meeting issued by the Commission on May 5, 1983, observed, "the unfixing of commission rates... and the establishment of discount brokerage operations have raised new questions regarding the proper role of financial institutions, such as banks and trust companies, in the securities brokerage industry."[1] Regulatory policies should be designed to help realize the full potential of the benefits sought by the introduction of competitive commission rates.

Prior to the introduction of price competition, the only discount brokerage services available in Canada were for transactions executed on the U.S. stock exchanges. There was no need to examine who should be allowed to provide or market discount brokerage services or how such brokers should operate. Nor had financial institutions generally tested the boundaries of their permitted securities activities.

Competitive pricing, however, has created an opportunity for banks and trust companies to benefit from increasing their involvement in securities activities if they are allowed to by the relevant regulatory authorities. Prior to the introduction of competitive rates, the banks and trust companies could not negotiate fees below the fixed schedule in respect of retail trades. However, in the absence of any restrictions, the financial intermediaries now will be able to serve as "retailers" of brokerage services, negotiating low commission fees with specific brokers and marking up or packaging brokerage services for sale to investors in conjunction with the banking services they already market.

Banks and trust companies potentially can benefit from offering retail brokerage services by increasing their fee (as opposed to interest spread) business and also by increasing the proportion of the retail investors' investments which flow through their institutions. They can realize not only a new, no-risk, source of revenues but, more importantly, a stronger bond with a broader client base. The response of at least one bank to this opportunity appears to threaten the traditional separation of banking and securities functions. Consequently, it would appear that the existing regulatory framework should be re-examined in light of these developments in the market for brokerage services.

The issues being dealt with at the O.S.C. meeting concern the structure and evolution of the financial services sector in a period of rapid economic, technological and regulatory change. The criteria to be used in determining the appropriate restrictions to place on competition have been clearly stated by the O.S.C. in past decisions.

The Commission stated in its decision to unfix brokerage commission rates that:

> The O.S.C., being charged with regulatory responsibilities, has a duty to ascertain and declare where the public interest lies and to do what should be done to protect this declared public interest. The O.S.C. acknowledged, in calling this hearing, that an important aspect of the public interest is identified in section 32 of the Combines Investigation Act, Chapter C-23, R.S.C. 1970, as amended. Counsel to the Director stated the public interest in his written submission of March 12, 1982, at page 2, in language accepted by the O.S.C. as follows,

> 'It is the law of the country, whether we agree with it or not... that price fixing as such is thought to be against the public interest. All of the witnesses agree... that competition should only be displaced in the exceptional case and that as a matter of policy, people should be able to compete.'[2]

With its broad supervisory powers, the actions of the Commission often have important economic consequences to the securities industry and its competitors as well as for users of the securities markets. However, the concern of the O.S.C., insofar as it attempts to regulate the competitive environment in the public interest, is the protection of investors and the efficiency of Canadian capital markets not the provision of economic benefits to particular participants in the market for brokerage services. To achieve these objectives, the Commission must also be concerned with the quality of the market for brokerage services.

Under normal circumstances a competitive market structure is in the public interest since it encourages both allocational and operational efficiency in markets. The exception of regulation is justified only in situations where there is a clearly identified market failure or a specific social objective which justifies impeding normal competitive forces. The O.S.C. showed concurrence with this view in quoting the Director's submission on the unfixing of brokerage fees: "This presumption in favour of competition finds legislative expression in the Combines Investigation Act, which outlaws various anti-competitive types of behaviour. In large measure, the use of regulation is limited to the control of situations in which the competitive mechanism can be shown to be inoperative."[3]

In adopting these views the O.S.C. has demonstrated its intent to pursue policies which encourage beneficial competition. The decision to unfix brokerage commission fees has added a new dimension to competition within the industry. It already has had the result anticipated by the O.S.C. when it stated: "The so-called 'discount broker' may emerge, as indeed it has in Toronto in the commodities field, for the investor not needing the advice or the range of services now routinely available through most brokerage firms."[4]

Effective competition of this type may now be enhanced by service competition from outside the industry through financial institutions having networking[5] relationships with securities firms. This development was anticipated by most participants in the July 1982 institutional ownership and diversification hearing. In its Report to the Minister, the O.S.C. quotes counsel for the Toronto Stock Exchange as follows,

> - it is not necessary to prohibit agency relationships in order to maintain separation of function;
>
> - the availability of "networking" will provide flexibility for an increase in the range and variety of services that can be made available to an investor from a single source;
>
> - the creation of agency relationships is not irreversible and the rules could therefore be made more restrictive if, contrary to expectations, networking[6] proves to have adverse consequences.

In noting the view presented by counsel for O.S.C. staff, the Commission states in its Report, "Mr. Crawford argues for the benefits of so called 'one-stop shopping' as offering the clients a whole range of investment alternatives. The

industry, while arguing for separation of functions, also argues for the benefits to consumers of having various financial products available under one roof."[7] The Report also quotes Commission staff counsel: "it is not necessary that a single corporate entity own all the parts of the network. Ownership and ultimate control can remain diverse. This is important as a guide to what could be an attractive form of development in Canada."[8]

While recognizing the widespread concurrence among participants in the hearing on institutional ownership and diversification that networking relationships would be beneficial to the public interest, the O.S.C. had reservations. It stated in its recommendations,

> However, if the core function concept is valid, since investments are more often sold than bought, one-stop shopping on an agency basis seems little different than the concept of one owner with a range of financial products. The financial services concept, where the products offered are insurance and pooled managed funds does not encourage the conclusion that one-stop financial shopping gives a range of products plus unbiased, independent, financial advice. While the existing arrangements appear to have caused few problems, no evidence was adduced as to their nature and size. Any further extensions of such agency relationships, except on an individual and approved basis as was done in the case of the registered retirement savings plans, should receive the prior approval of the Superintendent of Loan and Trust Companies, the Commission and the SROs.[9]

Canadian capital markets, heavily influenced by their American counterparts, are in the midst of a number of significant changes. These include:

- the proliferation of new financial services and products;

- internationalization and institutionalization;

- structural deregulation

- technological advances which are rendering geographic and product limitations obsolete; and

- the disintegration of distinctions between market and financial intermediaries and the services they offer as the process of product extension rapidly brings them into competition along a broad front.

The near-term prospects of financial innovation, of de- and re-regulation, and of corporate recombinations have opened up new opportunities in the industry which have been matched by the willingness of industry leaders to take on the risks and returns promised thereby. To date, the ability of the industry to respond and adapt has been exemplary. It is important to maintain the independence of the securities industry in order to encourage strong competition between market and financial intermediation - the two alternative vehicles for channelling funds into capital markets.

Forms of regulation are needed that allow investors to receive the benefits of increased competition through networking while avoiding the potential anti-competitive effects of "one-stop shopping" which, in the near term, could result in the effective control of the securities industry by competing financial institutions.

Existing Regulatory Framework

In the midst of the accelerating pace of service innovation, financial markets remain among the most heavily regulated areas in the Canadian economy. The regulatory framework which will ultimately determine the role of financial institutions in discount brokerage consists primarily of the Ontario Securities Act, Regulations and Policies, securities industry self-regulation and the Bank Act as well as the extensive regulatory structures which govern other financial institutions in Canada, including trust and loan companies, credit unions (and caisses populaires in Manitoba and Quebec), mutual funds, and life insurance companies. As is the case with banks and securities firms, each sector is independently regulated. Even within a particular sector, such as the securities activities of banks, regulatory issues are often complicated by divided jurisdiction between various agencies and different levels of governments.

Price, entry, and safety regulations are common to all the regulatory frameworks that govern Canada's financial service sector. Most of these regulations, and the policy assumptions which underly them, remain in force.

One such assumption is the desirability of separating the functions of banks and securities dealers in order to avoid potential conflicts of interest and undue concentration of economic power. The former could occur in respect of corporate securities, the issuers of which may also borrow from banks. Numerous other potential conflicts arise from the underlying choice between raising capital from financial institutions or directly from the public. The latter could occur by virtue of injurious competition from the financially powerful banks in the market for brokerage services.

The traditional policy view in North America has been that to separate the functions of banks (taking deposits and lending and investing for their own accounts) from those of the securities industry (underwriting, distributing, advising, and trading) is the most effective way to ensure efficient capital markets and to preserve freedom of choice for those seeking capital and those with savings to lend or invest.

Although it has no specific statutory authority, separation of functions in the financial services sector has been encouraged by such measures as registration requirements and solicitation restrictions found in the Ontario Securities Act, ownership restrictions and suitability rules contained in the T.S.E. by-laws, and restrictions on bank activities as specified in the Bank Act. In fact, the current Bank Act is specifically designed to protect the securities industry (as well as the leasing and data processing industries and the fiduciary business operated by trust companies) from the competition of banks. The rationale for this statutory separation of banking from the securities industry was stated in the 1978 White Paper on the Revision of Canadian Banking Legislation as follows:

> The securities industry, by underwriting new issues and by maintaining secondary markets and consequently liquidity for outstanding securities, plays a significant role in our capital markets. It is important that it should continue to be a strong segment of these markets and that the corporate sector should continue to have a choice of sources for funds, that is, the banking sector or the public through the underwriting facilities of an independent dealer. To help ensure this choice, and taking into account conflict of interest concerns and possible undue concentration of power, it

is proposed to define more precisely the role of banks in the sale of corporate securities.[10]

While regulatory barriers separating the providers of financial services are blurring and will likely diminish further, the regulation of the services being provided is increasing and will likely continue to grow. These trends are occurring at the competitive intersections[11] of the financial services sector, which resemble traffic intersections simultaneously patrolled by a variety of policemen, each regulating a particular type of vehicle in accordance with a different set of rules.

Regulatory reform of a single industry involves enormously complex questions, particularly when the industry is as complicated as banking or securities. But the question of regulatory reform affecting competition between two or more industries raises a whole set of new problems because the change in the pattern of regulation of one industry changes the environment in which the other operates. It is these interactions that pose particularly difficult public policy concerns for those with regulatory responsibility. In this context, the preliminary task of identifying key issues may be just as significant as formulating definitive regulatory responses. The following sections are intended to assist in this task by identifying different types of competition and the characteristics of each. Drawing these distinctions is important to understanding the benefits and costs associated with specific alternative regulatory responses.

Policy Implications

II-1. The introduction of price competition in the securities industry has led to initiatives by other

participants in the financial services sector which challenge the traditional concept of separation of function. A regulatory response may be required if the principal of separation of function is to be maintained by ensuring that securities-related activities remain an incidental function of banks and other financial institutions.

PART III

INTRAMODAL COMPETITION AND DISCOUNT BROKERAGE

Introduction

Several distinct forms of competition must be considered in the securities industry. The most obvious form is that between firms within the industry. For example, members of the Toronto Stock Exchange compete for the business of investors on the basis of the services they offer and, since April 1, 1983, on the basis of price. The T.S.E. also competes with other exchanges, domestic and foreign, on the basis of operational efficiency and regulatory standards.

The securities industry as a whole competes with other segments of the financial services sector, primarily on the basis of the investment products and associated services that they offer. The product alternatives offered by the industry may be unique to that sector or may be very similar (even identical) to those offered by others.

In this submission, competition anong securities dealers and among stock exchanges is referred to as "intramodal" competition. Competition between market intermediaries and financial intermediaries is referred to as "intermodal" competition. The terms intramodal and intermodal are adopted from usage by regulators of the transportation and telecommunications industries. In these industries there also is competition both within a mode, or type of carrier, and between modes.

At present the issue of interest to the O.S.C. in terms of intramodal competition is the role and nature of discount brokerage. As discussed earlier, the recent trend in the financial services sector has been to remove regulatory barriers to competition. One of the anticipated effects of the introduction of retail price competition was that discount brokers would emerge and offer a low-cost execution alternative to investors. The U.S. experience cited during the 1981 hearing, as well as the predictions of Canadian industry representatives, the O.S.C. staff, and the Director, all anticipated the entry of discounters, including those offering no-frills service. It would appear consistent to modify the T.S.E.'s by-laws and, if necessary, the Regulations made under the Securities Act, which were written prior to the unfixing of rates, to ensure that they do not unduly impede the demand for and development of a full range of services, including those which offer no investment advice to clients.

Benefits of Intramodal Competition

The O.S.C. and other securities regulators have taken policy measures, such as unfixing commission rates, in apparent recognition of the significant benefits of increased competition within the securities industry. Increased product diversity is one such benefit. While most retail clients appear to want the full packages of services traditionally offered by securities dealers, a segment of the market considers itself to be better served by low-cost, no-frills executions.

The evidence available on the U.S. experience indicates that the market segment which takes advantage of discount services is small. The U.S. Securities and Exchange

Commission reported that by 1980, five years after rates were unfixed in the U.S., the discount brokers' share of retail commission revenues was only 6 per cent. Although the S.E.C. did not update these figures in the 1981 Report, unofficial sources estimate that by 1982 the market share of discounters had almost doubled to over 10 per cent.

Encouraging diversity through increased competition is in the public interest since doing so both increases consumer choice by eliminating unwanted services, and better matches the services provided by the industry to those sought by investors.

In addition, the fewer impediments there are to competition, the greater the pressure on firms to operate efficiently. Intramodal competition forces all firms to be cost-conscious in their effort to meet the demands of investors.

Problems With Intramodal Competition

Economists, businessmen, and regulators all agree that, in general, competition is the most efficient market structure. Exceptions occur only when there is an imperfection in the market that results in its failure to operate efficiently. The list of possible imperfections include monopolies, high transaction costs and public goods. Market failures justify regulatory intervention if and only if the imperfections introduced by regulation create less inefficiency than the imperfections of the competitive market.

In the securities industry the most significant market failure arises from the inadequacy of information in

an unregulated securities market. Experience has demonstrated that a small proportion of market participants (often those issuing, underwriting, or dealing in securities) have information that is unavailable to investors generally. Moreover, by releasing false or misleading information, informed promoters can make huge gains at the expense of misinformed investors. Exploitation of such situations can lead to a loss of confidence in the integrity of securities markets and consequently impair capital formation. This problem is the primary impetus for the extensive securities regulations that now exist. The function of such regulation is primarily to avert situations of information being withheld and false or misleading information being given out. As much as is possible, securities regulation seeks to avoid any investors gaining at the expense of others by having access to information that has not been generally disseminated. This is the purpose of the timely and continuous disclosure requirements of the Ontario Securities Act and the stock exchange by-laws.

While policies which encourage increased competition will generally be beneficial, restrictions may be justified if the protection of investors with respect to the fair and equitable availability of information is affected.

The clients of "no-frills" discounters receive less information from their brokers than do clients of full-service firms. Such discounters cut costs, in part, by providing little or no advice. Nevertheless, regulatory intervention is not required to protect the public interest as long as investors knowingly choose to deal with a broker who does not provide research or advice. There are many alternative sources of such information which investors may prefer to the advice given by brokers. Furthermore,

subscribers to the efficient-market hypothesis would suggest that all publicly available research information is instantly reflected in the market in any event; hence, it is not important that all individuals receive research information - only that the market generally has it (i.e. ensure disclosure and restrict misinformation).

Policy Implications

III-1. Competition among securities dealers and among exchanges should not be impeded except to the extent that it is necessary to ensure full disclosure or to avoid other informational and market manipulation problems.

III-2. Discount brokerage is a valuable element of the competitive market. Hence the development of this sector should be facilitated, as should other innovative service offerings. The emergence of discount brokers who have no research staff and give no advice is not inconsistent with the consumer protection mandate of the O.S.C., since the clients of discounters have many alternative sources of information which are regulated by the O.S.C.

III-3. Discount brokers may or may not take the form of "no-frills" brokers. If they do not engage in solicitation and advice, the primary rationale for the suitability rule is absent. On the other hand, if a discount broker either solicits orders or offers advice, the same rules should apply to that discounter as apply to full service firms since the services they offer are similar, although priced differently.

PART IV

INTERMODAL COMPETITION AND THE ROLE OF FINANCIAL INSTITUTIONS

Introduction

Intermodal competition is that which prevails between market intermediaries and financial intermediaries. However, there is an important distinction to be drawn between competitive situations in which the various participants in the financial services sector offer distinctly different investment products and those situations in which they offer similar investment products.

Indirect Intermodal Competition

To a large extent intermodal competition takes the form of competition for the investors' dollars between investment products and services that are unique to each sector. For example, securities dealers offer direct investment in the securities of corporations; banks offer guaranteed income certificates; trust companies offer units in pooled investment funds; and life insurance companies offer various insurance policies. Investors choose the investment, or mix of investments, which best serves their needs. The choice of the financial institution is synonomous with the choice of the product.

For convenience, this type of competition is referred to here as indirect intermodal competition. The competing segments of the financial services sector compete for a larger share of the total investment dollars through product design, marketing efforts, and ancillary services.

There is no apparent concern regarding the role of financial intermediaries with respect to indirect intermodal competition. It is a reality of the financial marketplace. In their thorough study entitled "The Management of Change in the Canadian Securities Industry" which was commissioned by the Toronto Stock Exchange, Shaw and Archibald commented on this feature of the competitive environment as follows:

> The Canadian securities market competes for the funds of money managers in Canada and abroad. In this sense, securities compete for funds with all other goods and services, and real and financial assets. Two groups provide competition: Canadian financial intermediaries; and foreign securities markets.[12]

Direct Intermodal Competition

To some extent market intermediaries and financial intermediaries may offer competing products which are very similar. For example, investors may maintain deposit accounts with banks or trust companies or receive interest on credit balances maintained with securities dealers. (To date, the economic significance of this example of direct intermodal competition appears to have been minimal, since deposit taking is a primary function of banks and trust companies, whereas it is only a subsidiary service of brokers.) This type of competition is here referred to as direct intermodal competition.

Direct intermodal competition would exist in the provision of brokerage services only if the banks or other financial intermediaries executed trades themselves. This is one way in which one-stop shopping can be offered to investors. Under the current regulatory environment, direct

intermodal competition in the provision of brokerage services is not permitted. (The acceptability of very similar arrangements, such as the TD Bank's "Green Line Investor Service" in which they sell the brokerage services of independent securities dealers is the subject of the O.S.C.'s June meeting. This type of arrangement is considered to be networking, which is discussed in Part V, rather than direct intermodal competition.)

Although direct intermodal competition is not permitted in the current regulatory environment, and no one is proposing that it should be permitted at the present time, it is useful to examine it in some detail in order to facilitate the ensuing discussion of networking which will argue that certain networking structures are virtually equivalent to intermodal competition in terms of their implications for market structure. The following analysis of intermodal competition therefore is provided in order to assist in illustrating the essential distinction that will be drawn between different types of networking and which form the basis of the recommended approach to protecting the near-term effectiveness of competition in the market for brokerage services. Furthermore, the issue of direct intermodal competition will arise when the O.S.C. reconsiders its 1982 policy stance on institutional investment, as recommended in its December 1982 Report to the Minister.

The questions relating to the desirability of direct intermodal competition in the emerging financial services sector have recently become the focus of a U.S. Congressional inquiry. Unfortunately, the U.S. experience is too recent to be of much assistance to Canadian regulators at this present time. Even if the U.S. experience were clearer, its relevance for Canada would be limited since the banking

systems of the two countries differ radically. Consequently, arguments as to the probable effects of increased direct intermodal competition must rely on analytic insight rather than empirical evidence.

Prior to the introduction of fully competitive commission rates, banks played a minor role in accepting orders for trading securities. The intent was to provide an incidental service to their clients which complemented their custodial and safekeeping services, without engaging in serious competition for brokerage business.

If the banks are allowed to compete directly, the market for brokerage services could be radically altered. Robert MacIntosh, President of the Canadian Bankers Association, elaborated on the strength of the banks in a speech to the Investment Dealers Association of Canada during the Bank Act revision:

> While your industry [the securities industry] has 570 offices in Canada, there are 7,500 bank branches and about 6,000 near banking branches. It is inconceivable that governments would deliberately abandon that distribution system. One can imagine what would happen to the sale of Canada Savings Bonds. When the interests of provincial governments are directly affected, I think you can be reasonably sure that they will prefer a wide distribution of securities. Two years ago, it is worth remembering, the Alberta government went out of its way to make sure that the chartered banks could distribute the equity of the Alberta Energy Company, even though this was a departure from the then recently enunciated policy of the provincial securities commissions that banks should not underwrite corporate securities.[13]

The securities industry would argue that the current role of the financial institutions as providers of securities trading is analogous to the role of securities dealers in paying interest on credit balances in client accounts. Such accounts are presumably intended as a convenience to those investors who occasionally find themselves holding a cash float between the sale and purchase of securities. Securities dealers would argue that this "service" is not intended to compete seriously with the bank and trust company deposit services.

Despite these minor incursions by market and financial intermediaries into each other's territory, they have generally been content to maintain a functional separation. The recent unfixing of commission rates, however, has led to new opportunities for crossing that boundary. The central question facing the O.S.C. is whether or not the public interest and capital market efficiency are likely to benefit if the functional separation between market and financial intermediation is eroded.

The following discussion of the benefits and problems frequently associated with intermodal competition deals only with direct intermodal competition. Indirect intermodal competition is a fact of life in the financial market and is not an issue at the present time.

Benefits of Direct Intermodal Competition

In general, increased competition is in the public interest since it enhances both operational and allocational efficiency. If direct intermodal competition is permitted in the securities industry, a whole new dimension would be added to the competitive environment of that industry. Four

potential benefits may be realized, subject to the caveats discussed below. The potential benefits are:

- economies of scope;
- increased investor convenience;
- increased market liquidity; and
- decreased concentration in the Canadian securities industry.

Economies of Scope

Economies of scope are realized when a single firm can produce two products or services more economically than two separate firms can. Whenever two services are closely related (as are the services of financial and market intermediaries), it may be possible to eliminate a significant amount of redundant overhead by offering the services jointly.

If economies of scope exist for the production and marketing of brokerage and banking services, allowing direct intermodal competition would enable the financial services sector to operate more efficiently (at lower total cost) than it can currently. However, if there are no economies of scope, there will be no cost advantage to offering brokerage and banking services jointly. In a competitive environment, this would reduce the incentive for firms to engage in direct intermodal competition and for investors to utilize firms that offer the services jointly. Thus, in the absence of economies of scope, banks would not gain a competitive advantage in terms of price by offering brokerage services - unless they were to consider it profitable to invest in subsidizing their brokerage services in the short run in order to attract business which will be profitable in the

long run. (See the discussion below on subsidization of competitive services.)

Sufficient data are not available to clearly demonstrate whether economies of scope exist for brokerage and banking services. Although it can be argued that for certain overhead costs, such as advertising, the two services may be as cheap as one, several factors suggest that economies of scope are small or non-existent. There is no indication that in Europe where bank and brokerage services are offered jointly, savings are achieved relative to the traditional North American system. Furthermore, few, if any, administrative activities could be eliminated by combining the services to offer one-step shopping.

The selling of securities appears to require extensive personal and direct selling effort. On this score, banks are at a competitive disadvantage relative to securities dealers. They can be expected to remain so since they are unlikely to match the sales force of the securities dealers. Since banks do not now use such a sales force for their other activities, no significant savings can be obtained by offering banking and brokerage services jointly. Additionally, banks would be unable to execute orders with existing facilities. Given these considerations, both expectations of increased efficiency and fears that the securities industry will be unable to be price competitive with financial intermediaries that offer brokerage services appear to be unwarranted. As discussed below however price is not the only relevant competitive factor.

Increased Investor Convenience

Although there is no evidence that the financial services sector can cut their total costs by packaging

services to offer one-step shopping, it does appear that investors would be able to reduce their transactions costs in terms of personal time and effort. One-stop shopping is more convenient (lower transactions costs) than multi-stop shopping.

For example, if an investor both places orders and maintains a line of credit with a bank, administrative procedures could be set up so that upon placing an order the bank could arrange for execution, increase or repay the investor's loan, and transfer the securities to or from bank safekeeping facilities. This would save the investor the time and trouble of making credit and other administrative arrangements on his own. While this arrangement would not introduce new services, it would introduce a new, consolidated, and more convenient, package of the services that are currently available. The investor may also be able to utilize funds more efficiently by consolidating all transactions in a single account.

Improved investor convenience does not require direct intermodal competition in order to be realized, however. It can be achieved by financial and market intermediaries co-operating in the provision of joint services without either one actually offering services in direct competition with the other - that is, by establishing networking relationships which are discussed later. Furthermore, convenience can be achieved with networking relationships whether one-stop shopping is offered or not.

Increased Market Liquidity

If investment in the securities market is made more convenient and less costly for retail investors, they are likely to participate to a greater extent. As has been

clearly demonstrated in past hearings, the industry considers retail participation to be very important to the health of the financial market. It is for this reason that "the [Toronto Stock] Exchange and the [Ontario Securities] Commission have expended a great deal of attention and regulatory concern toward increasing the degree of participation by individuals in the Canadian securities market."[14] The reason for their concern is that market liquidity and in turn allocational efficiency, depend on a steady flow of trading activity. The larger the number of independent decision makers and the larger the number of individual trades, the more liquid the market.

Whether this potential benefit would be realized if intermodal competition were permitted depends on whether retail participation would increase significantly in response to increased convenience and more aggressive marketing. Whether the impact is significant is a matter of pure speculation; however, it is highly unlikely that the effect would be negative in the near term.

Like increased investor convenience, this benefit also can be realized by means of networking.

Decreased Concentration in the Canadian Securities Industry

Allowing direct intermodal competition is equivalent to allowing new entry (i.e. banks and trust companies) into the industry. The financial resources and extensive branch networks of the banks and trust companies will enable them to grow quickly and compete directly with the large securities dealers. This situation is likely to reduce the market share of the currently dominant firms in

the securities industry; hence, concentration within that particular segment of the financial services sector may be reduced, at least in the short run.

Problems with Direct Intermodal Competition

The securities industry has voiced the concern that the financial intermediaries have so much power that they would have an unfair competitive advantage if they were allowed to compete directly with the securities industry. The industry suggests that the idea of genuine competition over an extended period between banks and securities firms is illusory. Given the relative stature of the banks, the competitive advantage that can be obtained by combining securities activities with commercial banking could result in increased concentration of economic power, as well as an increase in conflict-of-interest situations.

While these concerns are valid, they should be distinguished from concerns based on the securities industry's lack of success at indirect intermodal competition with the financial intermediaries. Shaw and Archibald evaluated the results of that competition (as of 1977) as follows:

> In terms of competition for the personal saving dollar, the financial intermediaries have clearly outdistanced the market intermediaries. They have accomplished this largely by offering short-term debt instruments through a mass merchandising distribution system. In addition to short-term debt instruments, financial intermediaries have benefitted from favourable tax legislation for pension and retirement funds.

> The fact that financial intermediaries invested the majority of their managed funds in publicly offered securities saved the market intermediaries in Canada from an even more serious contraction of business than we have witnessed. Many observers have pointed out that market intermediaries in Canada largely abandoned competition for the retail customers in order to serve the "big ticket" business of the institutional portfolio money managers.[15]

This comment does not imply that the financial intermediaries have achieved a position of dominance by doing a better job of serving their clients than market intermediaries. The firms which best serve the public and operate most efficiently tend to dominate in sitations of direct competition; however, in this situation, it is more likely that the key determinant of relative success (i.e. size) is the preference of retail investors for the products of the financial intermediaries.

In general, for investments with equal expected rates of return, investors prefer those which are less risky. Financial intermediaries are able to reduce investor risk by offering short-term investments (less interest rate risk than long-term investments) and guaranteed interest rates. Furthermore, institutions have sufficient resources to diversify their investments so as to realize a much lower portfolio risk for a given expected return than can an individual investor. Consequently, for many investors, the investment products offered by financial intermediaries are more attractive than the investments held by those financial intermediaries which they could buy directly through a broker.

Financial intermediaries play an instrumental role in the daily financial life of virtually every person (i.e. deposit taking, cheque clearing, personal loans, etc.) In

addition, intermediaries control the funds they intermediate, since they, rather than their clients, make all investment decisions. The securities industry, at least in its brokerage function, has little control over directing the flow of funds since the client decides how his funds are to be invested - although the client may depend on his broker's advice, in part.

These factors contribute to the immense financial power of the financial institutions relative to the securities industry. Their extensive branch networks, frequent contact with the general public, and resources available for publicizing their services would give them a significant edge in any direct competition with the securities industry for retail brokerage business.

While the competitive edge of the financial intermediaries poses a threat to the securities industry, it is not in itself a problem that warrants regulatory restriction of competition. For example, it is conceivable that retail investors could be better served by the financial institutions and that their direct participation in the securities markets could be encouraged through more convenient access. This would imply that the capital markets could be well served by allowing direct competition. There are, however, additional considerations.

If financial intermediaries are able to exploit their advantage to capture a very large share of the business for which they are allowed to compete directly, it could be argued that the result would be anti-competitive, for three reasons:

- increased concentration;
- conflicts of interest; and
- regulatory asymmetries.

Each of these concerns is discussed below. First, however, it is worth noting that the effects of direct intermodal competition would depend on the extent to which some restrictions were retained. If banks were allowed to offer all the services that brokers now offer, as well as their conventional banking services, it is distinctly possible that a European-style system would result.

However, if financial intermediaries are restricted in their ability to solicit sales, give advice and manage underwritings, the risk associated with direct intermodal competition would be minimal. Institutional trading would not be threatened, assuming institutions were not allowed to execute their own orders, and the business of retail investors who want research with their brokerage services also would not be threatened. Consequently, only a small portion of the securities industry's total business would be vulnerable to competition from banks.

In the course of the hearing leading to the O.S.C. decision to require full price competition in the securities industry, the Toronto Stock Exchange and securities industry witnesses forecast a limited market share for discount brokers in Canada. Presumably, then, the securities industry is primarily concerned with the ability of the banks to expand that market segment significantly through combining discount brokerage with one-step shopping or to gain through it an undue and injurious competitive advantage in the provision of a wider range of services to investors such as margin borrowing and custodial services.

The experience of the United States provides limited insight into the effect of direct intermodal competition. The recent entry of the U.S. banks into the discount brokerage business demonstrates that they are able to provide discount services competitively. However, their involvement is too recent to provide a reliable indication of whether independent discounters are able to compete with banks or whether banks will gradually dominate the brokerage industry. Early indications are that the discounters will survive and the total market share of the independent, full-service firms will not shrink drastically. Since total revenue of discounters is reported to be only about ten per cent of total industry retail commission revenue, it appears that the short-term appeal of discounters is not sufficient to seriously threaten the viability of full-service brokerage or the industry as a whole. Whether the story will change in the long term is impossible to know. For this reason, a policy which initially expands the role of financial institutions in the brokerage industry without opening the door to direct competition, appears sensible.

The effect of the entry of financial institutions, would be that they would be likely to capture a significant portion of the retail discount business. They may also succeed in increasing the market share for discount brokerage by offering it as part of a one-step shopping service package. Except to the extent that such increased market share represents new investors attracted to securities trading by the marketing efforts of banks, existing securities firms would have to accommodate a revenue decline by a combination of firms leaving the business and remaining firms reducing their scale of operations. Of course, much of this shrinkage would have to occur in any case in order to make room for the new discount brokers other than banks, that are emerging.

Based on the preceding analysis, it would seem that although the effect of allowing the financial intermediaries to compete directly in providing discount brokerage services would not be negligible, there is little reason to believe that it would result in the domination of the securities industry, as long as clear restrictions on bank solicitation and marketing are imposed.

Increased Concentration

Although allowing new entry initially should decrease concentration, it is possible that if financial intermediaries compete directly in the market for brokerage services even if restricted to discount brokerage, the ultimate result could be an increase in concentration in the long run, reversing the short run decrease discussed earlier.

This result would occur if a few financial institutions offering discount brokerage services managed to dominate this emerging segment of the securities industry. Their dominance could potentially divert enough business from existing brokers to increase concentration if the loss of business is sufficient to threaten the viability of some of the existing brokers.

However, assuming bank solicitation and marketing are restricted there likely would be only a small increase in the technical measures of concentration, which would not be anti-competitive. Concentration is so low in the brokerage industry, relative to other Canadian industries, that a very major increase in concentration would have to occur in order for the result to have a significant negative impact on competition in the industry.

Conflicts of Interest

The primary products of financial intermediaries are their own instruments, such as deposits, guaranteed income certificates, etc. As a consequence, if they were in the position of giving advice to investors in respect of the securities of other issuers, there is the danger of conflicts between the recommendations that are in the best interest of the client and those that are in the best interest of the bank. In other words, financial institutions may be tempted to divert investment funds into their own products.

In theory these potential conflicts of interest would not be a problem if financial institutions were restricted to a purely non-advisory role. Unfortunately, there may be practical difficulties in ensuring that an investor who handles all of his financial dealings through a financial institution such as a bank does not seek and receive advice on securities investments from people at that institution, who are not properly qualified (with respect to registration requirements) to advise on securities investments.

Regulatory Asymmetries

The Ontario Securities Act and Regulations form only part of the regulatory environment affecting intermodal competition. Regulatory asymmetries could place the securities industry at a disadvantage which may not reflect their ability to provide service efficiently and compete effectively in an unregulated market.

Under normal circumstances, the removal of regulatory barriers to direct intermodal competition would be

expected to improve market efficiency; thereby, serving the public interest. However, efficiency may not be enhanced if regulatory asymmetries allow banks and trust companies to offer brokerage services in conjunction with their conventional activities when securities dealers cannot offer investors the same package of services. For example, regulations exist that restrict the lending by securities dealers to their clients and the types of deposit accounts they can offer. To allow banks and trust companies to offer all the services of a broker, while not allowing brokers to offer all the services of the banks or trust companies could put the securities firms at a competitive disadvantage in the market for brokerage services, even if they are more efficient as securities traders than are other financial institutions. As a consequence, it is conceivable that the public interest could be harmed by erecting unequal regulatory barriers that distort normal competitive capabilities.

The greatest attraction for financial institutions in offering brokerage services is that it will strengthen the bond between them and their clients. If investors utilize a financial institution for placing orders for securities trading, they are likely to also borrow from the same institution for investment purposes, store their securities with them, etc. Even if the bank or trust company loses money on the handling of trades, they would have the opportunity to recover their loss through interest and service charges associated with handling the investor's account. The securities industry would be placed at a competitive disadvantage if the banks were to price those services for which brokers compete very low and make up for these loss leaders on associated services for which brokers cannot compete. For example, banks could subsidize brokerage

services in order to attract clients who would then deal with the banks for their margin borrowing and custodial services. The securities industry's disadvantage in this situation would not arise from normal competitive forces but from the regulatory asymmetry that allows banks to offer brokerage services while limiting the banking services that brokers can offer.

Policy Implications

IV-1. Indirect intermodal competition occurs even if direct intermodal competition is inhibited by regulations that maintain separation of functions. This should not be a policy concern of regulators.

IV-2. Permitting direct intermodal competition would stimulate new and innovative service packages. Unfortunately, although encouraging direct competition normally benefits the public interest, if the regulators of the financial services sector were to allow financial institutions to compete directly with securities dealers in all forms of securities trading, the result may be anti-competitive. The anti-competitive outcome is the result not of inherent economic opportunities, but rather of existing regulation in other jurisdictions and the relative financial power of the banks and brokers which is primarily the product of regulation rather than unfettered economic forces. To remove a single barrier to direct intermodal competition would be inequitable since regulatory asymmetries would result. There can be no presumption that economic efficiency would thereby be improved.

PART V

NETWORKING AND THE ROLE OF FINANCIAL INSTITUTIONS

Introduction

The term networking became familiar to the O.S.C. during the 1982 hearing into institutional ownership and diversification. Networking refers to any situation in which a securities dealer and financial institution cooperate in the provision of investor services. For example, one firm may offer the services of another or the two firms may collaborate to offer a service jointly.

Networking is distinct from direct intermodal competition since the latter involves a firm providing, on its own behalf, services comparable to those traditionally provided by another financial sector. Direct intermodal competition would occur if banks offered brokerage services to their clients and were able to execute those trades themselves. Networking occurs if the bank offers brokerage services that are executed by a financially independent brokerage firm.

A distinction is drawn between "product networking" and "administrative networking" since the two types have significantly different market and regulatory implications. Product networking is used to refer to a networking relationship in which one firm sells the product of another firm. Service arrangements such as Toronto-Dominion's proposed Green Line Investor Service, where a bank accepts customer orders for the trading of securities and then places them for execution by a broker, are called product networking in this paper.

Administrative networking refers to networking relationships in which producers sell only their own services but cooperate in packaging them with others. In this instance, investors would continue to contact their broker rather than their bank in order to place an order for a trade. The bank and broker would have an administrative relationship which would permit an investor to arrange to have his bank account automatically debited or credited, or a loan from the bank to be processed automatically when an order is processed by his broker. Banks would not be permitted to solicit or market securities or brokerage services since orders would be placed directly with their affiliated brokers.

The development of administrative networking relationships could lead to a package of banking and brokerage services being offered which would allow investors to establish an investment account with a bank that would be administratively linked to a trading account with a broker. Upon placing an order with the broker - not the bank - the investor's bank account would automatically be debited or credited appropriately. The investor could maintain a credit line with the bank to automatically allow funds to be borrowed for stock purchased in a manner like that envisaged with TD's proposed Green Line Investor Service. All brokers and banks could participate in offering this service package despite the large number of brokers relative to banks since each bank could establish an administrative networking relationship with a number of brokers. In fact, there are no obvious obstacles to the creation of a system which would allow investors to deal with any broker and any bank. This could be accomplished by establishing a central clearing house for broker-banker transactions. While the resulting service would not be one-stop shopping, it would provide all the conveniences of one-stop shopping.

Either product or administrative networking relationships would enable the financial services sector to develop new service packages (the same as those which could be developed with direct intermodal competition) which would remove much of the effort currently burdening the typical retail investors who must frequently deal with several separate institutions (i.e. banks and brokers) in order to shift funds from one investment to another.

Administrative networking can be hampered by intermodal competition, as is illustrated by concern about access to, and the development of, the facilities of the Central Depository for Securities Ltd. At a recent hearing the Commission began to address issues relating to access to the facilities of the Central Depository for Securities Ltd., a clearing house collectively owned and governed by a small group of financial service institutions. This is one area where there is general agreement that a more rational and efficient system is desirable in order to reduce the cost of effecting securities transactions. The improvements require expanding access to the depository by developing an administrative networking relationship among banks and securities dealers. Yet the effort to develop a better system, which has been technically feasible for some time, is continually delayed and hampered by the efforts of particular firms, as well as industries within the financial services sector, to achieve competitive advantages. Those who already have access to the depository appear to be in no hurry to expand access so as to lower costs for their competitors. Regulatory incentives to encourage administrative networking in this area may be warranted. Similarly, regulatory incentives may be required to effect administrative networking relationships for the clearing of securities transactions as envisaged here.

Benefits of Networking

Networking has the potential of resulting in a number of benefits for investors and the capital markets, including:

- new service alternatives;
- increased efficiency; and
- increased retail participation.

New Service Alternatives

Through networking, new packages of traditional services can be made available to the investing public. The traditional structure of the financial services sector has led to the evolution of a system in which there is a high degree of separation of functions. This feature of the market has made it necessary for most investors to deal with a number of firms in order to obtain access to the various functions. Only middlemen, such as investment counsellors, have been able to offer investors a more complete package of services. Since a middleman must charge an additional fee, only investors with relatively large assets have normally availed themselves of their services.

Reducing the barriers which separate the functions will allow industry participants to join across boundaries to offer the public more complete financial services packages. However, the traditional separation of functions between banks and brokers would be maintained; hence, each sector would continue to exploit its strength and primary business with co-operative administrative procedures.

Efficiency

Financial institutions can assemble a package of

services which will reduce investors costs on a composite basis since the package would include those services of the bank which it provides most cheaply and those services of brokers which they provide most cheaply.

The primary potential benefit to consumers of networking is the convenience that can be achieved by centralizing all of their investment activities. At the present time, an investor often has to contact several people and initiate paperwork with each in order to mobilize investment funds. With networking this process could be rationalized.

Increased Retail Participation

An individual investor's decision to invest in the stock market directly or to invest in the products of a financial intermediary is affected by many factors. The most important is probably the expected return and risk associated with the investment alternatives. The relative transaction costs may also be important since they affect the net return that the investor stands to realize. By reducing transactions costs networking could benefit retail participation.

For many investors, accessibility is also an important factor. Securities dealers may not be considered to be accessible by investors for many reasons. For example, there may be no local offices of a securities firm. Also, many potential investors may feel intimidated by the unfamiliar environment of the securities business. Only recently have securities firms engaged in aggressive marketing efforts. Formalizing relationships between brokers

and banks could enhance the convenience and familiarity, thereby improving accessibility.

Retail investors may participate more actively in the securities market if transactions costs are reduced and accessibility is increased. Considering the concern that retail investment be encouraged in every way possible so as to maximize market liquidity, it seems desirable to encourage retail participation by making securities investment less costly and more accessible to retail investors. It also is desirable, however, that retail investors who are unsophisticated concerning securities and securities trading deal with representatives who are qualified, and are required to advise them. Normally, unsophisticated investors will tend to deal with full service firms rather than discounters as has happened in the U.S. Relying on administrative rather than product networking will avoid channelling new investors, attracted by the new service package, toward dealing with a bank, which may not be in a position to provide the investor with the advice required. Furthermore, with administrative networking investors could have access to the convenient service package whether they want discount or full-service brokerage.

Problems with Networking

To the retail investor product networking is very similar to direct intermodal competition. In either case, the investor places his order with the bank. Whether the bank or a broker executes the trade generally would be of no consequence to the investor. The problems of the potential conflicts of interest and the effect on competition for other services are not alleviated by disallowing direct intermodal competition in favour of product networking. The only problem that product networking avoids is that those

brokerage firms providing execution services to the financial intermediaries would receive commission revenues. In a price-competitive environment, the revenue decline for the securities industry could still be significant.

Administrative networking, however, does not give rise to the same propensity for conflict of interest situations or other adverse competitive effects. It also preserves the existing functional distinctions for regulatory purposes (i.e. regulated client relationships). If investors contact a securities dealer for all trading, they have the opportunity of seeking the securities dealer's advice and other services. Administrative networking does not appear to suffer from the problems of direct intermodal competition and product networking or from any other new significant problems.

Policy Implications

V-1. Product networking is virtually equivalent to direct intermodal competition in terms of its impact on the competitive environment in the market for brokerage services. The only important difference is that the revenues for execution services will not be diverted from the securities industry. The ability of banks to exploit regulatory asymmetries to capture a larger share of associated services (such as loan and custodial services), the resulting risk of increased concentration and the potential for conflicts of interest are no less with product networking than they are with direct intermodal competition.

V-2. As is the case with direct intermodal competition, it is unclear whether the potential dangers are likely to be significant in the Canadian market. The primary reason

for rejecting product networking as a desirable industry structure is that an alternative exists which promises to provide all the benefits of product networking while avoiding the problems, and allowing the financial services sector to develop incrementally.

V-3. Administrative networking promises to serve the public interest and benefit Canadian capital markets by encouraging the introduction of new service packages which will make securities investment more convenient and available at lower transactions costs for retail investors. By increasing the attractiveness of securities investment for retail investors, overall retail participation may be increased. The problems of direct intermodal competition and product networking should be avoided by administrative networking.

PART VII

SUMMARY AND CONCLUSIONS

Brokerage commission fees were unfixed as of April 1, 1983 after the O.S.C. determined that maintaining fixed rates was not in the public interest. One of the anticipated benefits of unfixing rates was recognized to be the emergence of new products such as discount brokerage services. The changing regulatory environment had made it necessary for regulators of the financial services sector to consider the questions of who will provide discount brokerage services to investors and what new service packages should be permitted.

A related question raised by these events concerns the role of financial institutions with respect to the integration of banking and brokerage functions. New opportunities exist for streamlining administrative systems to improve efficiency and customer convenience, in keeping with the maintenance of a healthy competitive environment in the market for brokerage services.

These questions have significant implications for the nature of the competitive environment in Canada's financial services sector. Restrictions on discount brokers may inhibit intramodal competition. Restrictions on the role of financial intermediaries may inhibit intermodal competition. Consequently, it is in the public interest to avoid unnecessary intervention, having regard for the complex and dynamic nature of the markets and the regulatory environment in question.

The O.S.C.'s primary objective must be to promote fair and efficient capital markets. In providing a meeting place for investors, the secondary equity markets have a dual responsibility. First, they serve as a pricing mechanism that promotes the allocation of available funds to the most profitable projects in our economy. Second, they are designed to promote operational efficiency so as to minimize the costs of effecting securities transactions.

The primary factors affecting the first concern, namely allocational efficiency, are market quality and liquidity. Here the ability of other financial institutions to increase individual participation in secondary equity markets could enhance allocational efficiency provided safeguards to ensure adequate investor protection exist or can be devised. These safeguards must address issues such as suitability requirements, possible conflicts of interest, and the potential for financial institutions to abuse their competitive advantages to engage in pricing strategies intended to reduce competition. The latter concern is best addressed by avoiding regulatory protection of inefficiency from normal competitive forces.

The participation of financial institutions in the securities industry could contribute to operational efficiency by reducing transactions costs, particularly for individual investors in remote communities. However, this objective can be achieved in ways that do not depend on the unfettered participation of financial institutions in the securities industry.

The Commission's Notice of Meeting implicitly focusses on the extent to which it should facilitate deregulation of certain aspects of competition between the

banking and securities industries. Based on the foregoing, albeit preliminary analysis, direct competition between banks and securities firms should continue to be restricted at this stage in the evolution of the financial services sector. This view is premised on a concern that wholesale removal of existing regulatory barriers could result in an increased concentration of economic power and conflict of interest situations for financial institutions, without any significant corresponding benefits to investors or the Canadian financial markets.

The competitive relationship between brokers and banks or other financial institutions can take a variety of forms. The costs, benefits and risk resulting from the competitive (or cooperative) relationship vary greatly among the alternative forms.

In theory, banks can undertake to offer brokerage services to investors through either direct intermodal competition or product networking. The former approach is not permitted under current regulatory restrictions since it involves execution of trades by banks. The latter approach utilizes brokers for execution although the bank accepts orders. TD's Green Line Investor Service illustrates the concept of product networking.

Both direct intermodal competition and product networking involve a risk that banks may be able to exploit an asymmetric regulatory environment to dominate the market for the types of brokerage services that they offer. Certain factors such as the established position (and sales force) of securities dealers in the market for trading, the absence of cost advantage for banks, and the limitations on the services that banks can offer other than pure order taking, suggest

that the risk of the brokerage industry being largely eliminated is very small; nevertheless, an alternative approach which avoids this risk while achieving the benefits through cooperative relationships may be preferable. Administrative networking achieves this goal.

All of the important benefits of allowing bank entry into the brokerage market can be achieved within the framework of separation of functions. A service similar to TD's Green Line Investor Service can be offered with investors placing their orders with a broker rather than the bank and with brokers rather than the bank soliciting and marketing brokerage services. Despite this change, the administrative linkage and customer convenience can be maintained. There is nothing to prevent securities dealers from entering into agreements with one or more banks to enable them to have securities transactions reported directly in a client's "bank account" or to have the bank provide the sorts of services contemplated by the Toronto-Dominion Bank's proposed Green Line Investor Service. Indeed, the opportunity for innovative service packages through administrative networking is virtually unlimited, while all participants in the market and regulatory process have an opportunity to move incrementally towards a more rationalized regulatory and competitive environment for the financial services sector.

In fact, a scenario can be forseen in which all bankers and all brokers cooperate to form a network which would permit an investor to have a special account for investment purposes at any bank which the investor could use for the purpose of trading with any securities firm, once the necessary paperwork was done to link his trading account with his broker(s) to his investment account at the bank. This

scenario maps out a highly competitive and flexible industry structure which would provide significant benefits in terms of operational efficiency and the public interest. In addition, it may even improve the efficiency of the capital market by attracting more active retail participation.

This scenario does not jeopardize the traditional functional distinctions between banking and securities industry services since clients remain those of the securities firm and the service package is marketed by the securities firm. Consumers wishing to trade in securities, other than on a completely unsolicited basis, would continue to be clients of securities dealers, and that relationship would continue to be regulated by securities administrators and the securites industry's self-regulating bodies.

Summary of Policy Implications

II-1. The introduction of price competition in the securities industry has led to initiatives by the other participants in the financial services sector which challenge the traditional concept of separation of function. A regulatory response may be required if the principal of separation of function is to be maintained by ensuring that securities-related activities remain an incidental function of banks and other financial institutions.

III-1. Competition among securities dealers and among exchanges should not be impeded except to the extent that it is necessary to ensure full disclosure or to avoid other informational and market manipulation problems.

III-2. Discount brokerage is a valuable element of the competitive market. Hence the development of this sector should be facilitated, as should other innovative service offerings. The emergence of discount brokers who have no research staff and give no advice is not inconsistent with the consumer protection mandate of the O.S.C., since the clients of discounters have many alternative sources of information which are regulated by the O.S.C.

III-3. Discount brokers may or may not take the form of "no-frills" brokers. If they do not engage in solicitation and advice, the primary rationale for the suitability rule is absent. On the other hand, if a discount broker either solicits orders or offers advice, the same rules should apply to that discounter as apply to full service firms since the services they offer are similar, although priced differently.

IV-1. Indirect intermodal competition occurs even if direct intermodal competition is inhibited by regulations that maintain separation of functions. This should not be a policy concern for regulators.

IV-2. Permitting direct intermodal competition would stimulate new and innovative service packages. Unfortunately, although encouraging direct competition normally benefits the public interest, if the regulators of the financial services sector were to allow financial institutions to compete directly with securities dealers in all forms of securities trading, the result may be anti-competitive. The anti-competitive outcome is the result not of inherent economic opportunities, but rather of existing regulation in other jurisdictions and the relative financial power of the banks and brokers which is primarily

the product of regulation rather than unfettered economic forces. To remove a single barrier to direct intermodal competition would be inequitable since regulatory asymmetries would result. There can by no presumption that economic efficiency would thereby be improved.

V-1. Product networking is virtually equivalent to direct intermodal competition in terms of its impact on the competitive environment in the market for brokerage services. The only important difference is that the revenues for execution services will not be diverted from the securities industry. The ability of banks to exploit regulatory asymmetries to capture a larger share of associated services (such as loan and custodial services), the resulting risk of increased concentration and the potential for conflicts of interest are no less with product networking than they are with direct intermodal competition.

V-2. As is the case with direct intermodal competition, it is unclear whether the potential dangers are likely to be significant in the Canadian market. The primary reason for rejecting product networking as a desirable industry structure is that an alternative exists which promises to provide all the benefits of product networking while avoiding the dangers, and allowing the financial services sector to develop incrementally.

V-3. Administrative networking promises to serve the public interest and benefit Canadian capital markets by encouraging the introduction of new service packages which will make securities investment more convenient and available at lower transactions costs for retail investors. By increasing the attractiveness of securities investment for retail investors, overall retail participation may be increased. The problems of direct intermodal competition and product networking should be avoided by administrative networking.

FOOTNOTES

1. Ontario Securities Commission, Notice of Hearing, Discount Brokerage and the Role of Financial Institutions, May 5, 1983.

2. Ontario Securities Commission Decision (25 June 1982) pages 9-10.

3. Ibid, p. 10.

4. Ibid, p. 15.

5. Networking involves securities dealers acting in an agency capacity for financial institutions such as banks or trust companies.

6. Ontario Securities Commission: Report (31 December 1982), p. 25 (quoting Submission of the Toronto Stock Exchange, Exhibit B, page 8).

7. Ibid, p. 26.

8. Ibid, p. 27 (quoting the Submission of the TSE, Exhibit D, p. 34).

9. Ibid., p. 28.

10. Department of Finance, White Paper on the Revision of Canadian Banking Legislation, August 1978, p. 34.

11. A competitive intersection occurs whenever the activities of securities dealers and banks overlap giving rise to competition.

12. Shaw & Archibald, (1977), page 65.

13. Robert M. MacIntosh, Executive Vice-President, The Bank Of Nova Scotia and Chairman, Bank Act Revision Committee, the Canadian Bankers' Association, "Competition Policy and the New Bank Act" Remarks to the Toronto Society of the Investment Dealers Association of Canada, October 17, 1978, p. 13.

14. Shaw and Archibald (1977), p. 66

15. Shaw and Archibald (1977), pp. 65-66.

SOURCES

1. Wolfson, Nicholas; Phillips, Richard M. and Russo, Thomas A., Regulation of Brokers, Dealers and Securities Markets, Warren Gorham and Lamont, 1977.

2. Edward, Franklin R. (edit), Issues in Financial Regulation, McGraw Hill, 1979.

3. Shaw, David C. and Archibald, T. Ross, The Canadian Securities Market: A Framework and a Plan. The Mangement of Change in the Canadian Securities Industry, Study Eight, the Toronto Stock Exchange, 1977.

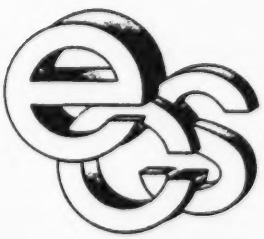
4. Ontario Securities Commission, Report to the Minister of Consumer and Commercial Relations Regarding Institutional Ownership of Securities Dealers Registered Under the Securities Act and Diversification into Other Businesses by Securities Dealers Registered Under the Securities Act in OSC Bulletin, 31 December 1982, Vol. 4, pp. 579A to 606.06A.

5. Ontario Securities Commission, Decision in the Matter of the Securities Act and in the Matter of Part XV of the By-laws of the Toronto Stock Exchange, 25 June 1982.

APPENDICES

CURRICULUM VITAE

JOHN D. TODD



ECONALYSIS CONSULTING SERVICES

May, 1983

PERSONAL PROFILE - JOHN D. TODD

Born: Oshawa, Ontario, March 20, 1950

Citizenship: Canadian

Address:

Business:

Econalysis Consulting Services Inc.,
366 Adelaide Street East,
Suite 415,
Toronto, Ontario
Canada M5A 3X9
Telephone: 366-1171

Home:

4 Sherbourne Street, N.,
Apartment 405,
Toronto, Ontario
Canada M4W 2T1

Telephone: 961-3438

Education:

Ph.D.	(in progress) University of Toronto Applied Economics Thesis Topic: "Pricing of Brokerage Services in a Regulated Market" Expected completion date: Fall, 1983 Supervisors: G.D. Quirin, G.F. Mathewson
M.B.A.	University of Toronto, 1975 (Resources Economics and Management Science)
B.A.Sc.	University of Toronto, 1972 (Electrical Engineering)

Current Positions:

President of Econalysis Consulting Services, a Toronto based firm specializing in economic and policy analysis of issues relating to the interface between the public and private sector (i.e. regulation, tax incentive).

Research Director to Ontario's Commission for the Inquiry into Residential Tenancies (The Thom Commission)

ECONALYSIS CONSULTING SERVICES

May, 1983

CONSULTING PROFILE - JOHN D. TODD

Founded Econalysis Consulting Services, Inc., in October, 1980

Recent Contracts:

- Development of a computerized package for analyzing the effects of alternative tax systems on business investment. Prepared for the Ontario Government Reference to study a separate personal income tax for Ontario.

- Analysis of the MacEachen White Paper on "Inflation and the Taxation of Personal Investment Income" for the Ontario Economic Council roundtable report.

- Economic Analysis of Tax Incentives for the Film Industry (joint project with Dr. E. Slack) for the Department of Communications.

- Economics Impact of Cultural Institutions for Ontario Association of Art Galleries in cooperation with Ontario Federation of Symphony Orchestras Toronto Theatre Alliance

- Analysis of the Canadian and American Experience with Partially Negotiable Brokerage Commission Rates for the Australian Merchant Bankers Association.

- Energy Efficiency of New Housing (joint project with Peat, Marwick and Partners and Scanada Consultants Limited) for Canada Mortgage and Housing Corporation.

- A Model of Supply and Demand in the Market for Housing for the Ontario Ministry of Housing.

- A Dynamic Simulation Model of the North York Secondary School System for Planning for Declining Enrollment for the Ontario Institute for Studies in Education (Department of Educational Planning).
  (joint project with Dr. S. Padro)

- The Benefits and Cost of Maintaining Fixed Commission Rates for Canadian Brokerage Services for the Ontario Economic Council.

- Policy Analysis of the Market for Life Insurance for the Ontario Economic Council.

Econalysis Consulting Services, Inc., currently employs three people on a full time basis, plus several on a part-time basis.

ECONALYSIS CONSULTING SERVICES

May, 1983

CONSULTING PROFILE (con't) - JOHN D. TODD

Expert Witnessing Experience:

1983 -	Client:	Director of Investigation and Research, Combines Investigation Act
	Tribunal:	Ontario Securities Commission
	Issue:	Institutional Ownership of, and Diversification by Securities Dealers.
1982 -	Client:	Director of Investigation and Research, Combines Investigation Act
	Tribunal:	Ontario Securities Commission
	Issue:	Institutional Ownership of, and Diversification by Securities Dealers.
1981 -	Client:	Director of Investigation and Research, Combines Investigation Act.
	Tribunal:	Ontario Securities Commission
	Issue:	The Unfixing of Brokerage Commission Rates.

siness and Consulting Experience Prior to Forming Econalysis Consulting Services

1980	Economic Impact of Art Galleries' Expenditures on their Local Communities for the Ontario Association of Art Galleries.
1980	Analysis of Canadian Stock Market Data for Canavest House Ltd.
1975, 1978, 1980	Redesign and periodic updating of the financial analysis methodology for Alfred Bunting and Company.
1977	"An Analysis of the Use of Component Internal Rates of Return for Fund Performance Measurement" for CN Investments.
1974-75	One of two organizers of the University of Toronto Consulting Service (12 student consultants with a summer budget of $35,000 from the Ontario Government).
1973-74	Constructed an APL package for teaching basic Business Finance concepts.
1972-73	Bell Canada. (Initial Management Development Programme).

ECONALYSIS CONSULTING SERVICES

May, 1983

ACADEMIC PROFILE - JOHN D. TODD

Research Experience:

1983 - current	Research Director of the Commission of Inquiry into Residential Tenancies. Directing a staff of four in-house researchers on various background studies on Ontario's housing market and the rent regulation literature. Managing numerous external contracts on topics related to the housing market and rent regulation.
1978-80	Research Officer for the Ontario Economic Council. Research was conducted in the following areas: - Regulation of the Securities Industry - Mineral Resource Taxation Policy - Federal-Provincial Energy Policy Other duties included managing ten external research contracts on topics in Regulation and directing the work of research assistants.
1977	Research into the Dynamic Transportation Problem with Professors Sethi and Bookbinder at the Faculty of Management Studies, University of Toronto.
1976	Wrote a case study of the potash prorationing scheme invoked by the Saskatchewan government in 1970. This case has since been used in the course entitled "Economics of Natural Resources" offered at the Faculty of Management Studies, University of Toronto.
1974-75	Developed an extension to the Limits to Growth World III Model incorporating commodity prices, technology, disaggregated regions and energy resources into the model.

Teaching Experience:

1982 - current	Computerized Business Systems, Canadian School of Management
1979 - current	Engineering Economy, Faculty of Engineering, University of Toronto.
1979-80	Introductory Economics at St. George Campus, University of Toronto.
1977-79	Economic Principles at Erindale College, University of Toronto.
1980 - current	Scuba diving instruction for Basic Diver, Sport Diver, Assistant Instructor and Instructor courses (National Association of Underwater Instructors certification)

ECONALYSIS CONSULTING SERVICES

May, 1983

Referreed Books:

Price Competition in the Canadian Securities Industry: A Test Case of Deregulation Ontario Economic Council Discussion Paper, forthcoming.

with G.F. Mathewson, Information, Entry and Regulation in Markets for Life Insurance - Part II Overview and Policy Implications Ontario Economic Council, 1982.

Refereed Articles:

with G.D. Quirin and S.P. Sethi, "Market Feedbacks and the Limits to Growth", INFOR, Vol. 15, No. 1, Feb. 1977

Other Publications:

with Douglas G. Hartle "The TAX-2 Model and Results" in A Separate Personal Income Tax for Ontario: An Economic Analysis, Ontario Economic Council, Special Research Report 1983

"Commentary" in Inflation and the Taxation of Personal Investment Income: An Analysis and Evaluation of the Canadian 1982 Reform Proposals (edit. D.W. Conklin), Ontario Economic Council, Special Research Report

Book Review:

G.D. Barney, P.H. Freeman, C.A. Ulinski Global 2000: Implications For Canada, Pergamon Press, 1981 in Queens Quarterly Vol. 89 (4), Winter 1982

OTHER ACTIVITIES:

- Active in squash, skiing, canoeing, bicycling, scubadiving, soaring.
- Enjoy theatre, reading, music.

REFERENCES: (Available on Request).